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IN THE

Supreme Court of the United States

OCTOBER TERM—1952

No. 185

SETH M. MILLIKEN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

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JUDICIAL PRINTING CO., INC., 82 Beekman St., N. Y.—BEekman 3-9084-5-6

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COMMISSIONER OF INTERNAL REVENUE,

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Your petitioner, Seth M. Milliken, hereby respectfully requests this Honorable Court to issue a writ of certiorari to the United States Court of Appeals for the Second Circuit to review the decision and judgment of that court which modified the decision of the United States Tax Court in this proceeding (R. 28).

The Tax Court modified a determination by the Commissioner of Internal Revenue of a deficiency in petitioner's 1943 income tax, and determined an overpayment of said income tax liability (R. 13).

Opinions Below

The opinion of the Court of Appeals is reported at 196 F. 2d 135 and appears at pages 20 to 27 of the Record. The findings of fact and opinion of the Tax Court are reported at 15 T. C. 243 and appear at pages 5 to 12 of the Record.

Jurisdiction

The decision of the Court of Appeals was entered on April 10, 1952 (R. 28). A petition for rehearing was duly filed on April 25, 1952 (R. 29) and was denied without opinion on May 5, 1952 (R. 35).

This Court's jurisdiction to review the judgment below is based on Section 1254 of Title 28 of the United States Code.

Questions Presented

1. Was it not error for the Court of Appeals to hold that petitioner could only deduct as a capital loss, not an ordinary loss or expense, $33,411.29 he paid in 1942* in settlement of transferee liability asserted against him because in 1941 he had received assets of the dissolved Ellingwood Corporation in exchange for its corporate stock?

2. Was it not error for the Court of Appeals to hold petitioner should be taxed as short term, not long term, capital gain the $58,372.44 he received in 1942 (in three payments) for certain rights and assets he had previously obtained in exchange for corporate stock of Cotwool Manufacturing Corporation which he had owned for many years?

* The transactions herein occurred in 1942. However, the tax year involved is 1943 because of the change to "pay as you go".

With respect to two of these three payments, a subsidiary question is presented: When petitioner, having an option to buy certain stocks, notifies the optionor that he wishes to buy them, and therefore receives the difference between market value and option price, is this a "failure to exercise" the option within the meaning of the Internal Revenue Code, Section 117 (g) (2)?

Statutes Involved

Internal Revenue Code Sections 23(e), 111, and 117(a) (b) and (g) are involved. The relevant portions are set forth in Appendix A, below, pages 23 and 24.

Summary Statement of Facts

The Tax Court made certain findings of fact, incorporating by reference certain other facts stipulated by the parties. Other facts were established by allegations and admissions of the pleadings.

1. As to petitioner's payments as transferee of Ellingwood Corporation:

In December 1941, Ellingwood Corporation was dissolved and liquidated. Dr. Seth M. Milliken, the petitioner, owned 75% of its stock. In 1942 agents of the Bureau of Internal Revenue asserted deficiencies in the corporation's taxes, and asserted that Dr. Milliken was liable therefor as transferee. The claims were settled by payments slightly over 50% of the liabilities asserted and Dr. Milliken paid his pro rata share, $33,411.29. (Stipulation, R. 15, 16)

The Tax Court held that this was deductible as an ordinary loss. The Court of Appeals reversed and held that it was a capital loss.

2. As to petitioner's receipts with respect to his Cotwool Manufacturing Corporation stock:

In February 1922, Gerrish H. Milliken agreed that he would buy from the petitioner, Dr. Milliken, the latter's stock in Cotwool Manufacturing Corporation on petitioner's request, at book value. In March 1940, when the book value was about three times the market value, Dr. Milliken requested Gerrish to buy it. Instead, after negotiations, Gerrish and the petitioner entered into an agreement on June 28, 1940, as follows: Petitioner transferred his stock to Gerrish, Gerrish in exchange gave petitioner first, cash and notes for the market value (or about one-third the book value) and second, the right in petitioner to buy back his proportionate share of the underlying assets of the corporation at prices based on the same valuation, any time up to December 31, 1942. It will be noted that by thus using the same figure for sale price and repurchase option price, Dr. Milliken was in a sense automatically protected against undervaluation.

In 1942, the tax year in question, Dr. Milliken told Gerrish that he wanted to buy certain of the underlying assets (corporate stocks and securities of various textile mills) at the prices fixed in the 1940 agreement. Instead, the corporation paid him $25,458.13 in February and $2,390.11 in July, representing the difference between the then market price and the contract price for twelve of the securities covered by the 1940 agreement. (Tax Court's Findings, R. 6-8.) The Tax Court held that this was a short term capital gain and the Court of Appeals affirmed.

In November 1941 petitioner purchased another of the assets as he was entitled to do under the 1940 agreement, paying $3.05 for a $30,527.25 participation in a note of Whitney Manufacturing Corporation. This was the price fixed by the 1940 agreement, at 10 cents per thousand dol-

lars face amount. In March 1942 Dr. Milliken received $30,527.25 for the note (R. 7).

The Tax Court held that this $30,527.25 (less the $3.05 cost) was short term capital gain and the Court of Appeals affirmed.

Reasons for Granting the Writ

1. As to petitioner's payments as transferee of Ellingwood Corporation:

(a) The decision of the Court of Appeals herein is in direct conflict with the decision of the Court of Appeals for the Third Circuit on the same matter. It is also in conflict with several consistent decisions of the United States Tax Court and with decisions of certain United States District Courts. (See Point I-A of brief annexed.)

(b) The Court of Appeals herein has erroneously decided an important question of federal internal revenue laws which has not been, but should be, settled by this Court. (See Point I-B of brief annexed.)

2. As to petitioner's receipts with respect to his Cotwool Manufacturing Corporation stock:

(a) The Court of Appeals herein has erroneously decided an important and fundamental question of federal law, with respect to the administration of the federal income tax. The question of tax treatment of the second part of a "step transaction" constantly recurs in the administration of the federal income tax. Every time an exchange results in piecemeal gains other than cash installments, the same basic question is presented. This precise question has not been settled by this Court. At least two decisions of this Court on closely similar questions are probably in conflict with the decision of the Court of Appeals herein and are directly in conflict with the principles

relied on by the Court of Appeals in reaching its decision herein. The confusion created by the decision of the Court of Appeals herein should be removed by a decision of this Court.

(b) The decision of the Court of Appeals herein also necessarily involved an erroneous interpretation of Internal Revenue Code, Section 117 (g) (2), when that Court held that petitioner's notice to the optionor that he wished to buy the stocks subject to the option, followed by his receipt of the difference between the market value and the option price, was a "failure to exercise" the option. The common law rule both in the United States and in England is that such a notice exercises an option without more. The question is thus one of general importance in the tax law and is a question which has never been passed upon by this Court, but should be decided by it to clarify a novel but recurring point of tax law.

WHEREFORE your petitioner respectfully prays that a writ of certiorari be issued directed to the United States Court of Appeals for the Second Circuit in respect of its decision and judgment, modifying the determination of the United States Tax Court, for a review thereof by this Court, and for such other relief as to this Court may seem proper.

Dated: New York, New York, July 8, 1952.

SETH M. MILLIKEN,
Petitioner

By JOHN W. BURKE, JR.,
Attorney for Petitioner

Certificate of Counsel

I hereby certify that I have examined the foregoing petition for a writ of certiorari and in my opinion it is well founded and the cause is one in which the petition should be granted.

Dated: July 8, 1952.

JOHN W. BURKE, JR.,
Attorney for Petitioner

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OCTOBER TERM—1952

No.

SETH M. MILLIKEN,

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v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Statement

A statement of facts is set forth in the foregoing petition. The statement therein of questions raised indicates the errors complained of. The relevant statutes are set forth in Appendix A hereto.

POINT I

The decision below concerning petitioner's payments as transferee of Ellingwood Corporation should be reviewed and reversed.

A. The decision below is in direct conflict with the decision of the Court of Appeals for the Third Circuit, and with other decisions.

In *Commissioner* v. *Switlik,* 184 F. 2d 299 (C. A. 3d, 1950), it was held that the taxpayer was entitled to deduct,

as an ordinary loss, payment he made in 1944 for a deficiency first asserted in 1942 as federal tax liability of a corporation completely dissolved and liquidated in 1941, because as a shareholder he had received assets from the corporation's liquidation, the amount of the settlement being substantially less than the tax liability originally asserted on behalf of the Commissioner. In the decision below, the Court held that the taxpayer could deduct only as a capital loss, *not* an ordinary loss, payment he made in 1942 for a deficiency first asserted in 1942 as federal tax liability of a corporation completely dissolved and liquidated in 1941, because as a shareholder he had received assets from the corporation's liquidation, the amount of the settlement being substantially less than the tax liability originally asserted on behalf of the Commissioner.

The two decisions are obviously in direct conflict on practically identical facts. The relevant provisions of the Internal Revenue Code governing both these tax years were identical. Each case presented the question of whether the loss should be treated as a long-term capital loss under Internal Revenue Code, Section 117 (a), deductible as computed in Section 117 (b), or as an ordinary loss fully deductible under Internal Revenue Code Section 23 (e) (2) covering losses by individuals "incurred in any transaction entered into for profit, though not connected with the trade or business."

The decision below reversed the Tax Court and did not attempt to distinguish the *Switlik* case but expressly regarded its determination as "contrary" thereto, saying:

> "The Tax Court held it to be an ordinary deduction under the authority of *Stanley Switlik*, 13 T. C. 121, subsequently affirmed by the Third Circuit, *C.I.R. v. Switlik*, 3 Cir., 184 F. 2d 299. We regard the issue as now controlled in this Circuit, however, by our contrary decision in *C.I.R. v. Arrowsmith* (*Bauer*), 2 Cir., 193 F. 2d 734, reversing 15 T. C. 876, and

holding such payments to be capital losses. Note, 38 A. B. A. J. 245, 1952. Our theory was in short that the payment operated to reduce the amounts received in the corporate liquidation and were more properly considered as a loss suffered in the return of capital or as a reduction of the capital gain, rather than as an ordinary hardship of business.

The fact that here the tax deficiency of the corporation was not asserted by the Bureau until after the liquidation had taken place is immaterial."

The rationale of the *Switlik* case is directly opposed to the reasoning of the decision below. The Court of Appeals for the Third Circuit said in its opinion in the *Switlik* case:

"The Tax Court, adhering to the principle of the taxable year, determined that the capital transaction was concluded in 1941, when the distributions became the taxpayers' property; that there was no sale or exchange in 1944; and that the losses sustained by the taxpayers as a result of the satisfaction of their liability as transferees, under the circumstances, were ordinary losses in 1944.

We agree with the holding of the Tax Court. The fact that the transferee liability which occasioned the losses grew out of distributions which resulted in capital gain in 1941 is not alone decisive. • • • not every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains tax provision. Those are limited by definition to gains from 'the sale or exchange' of capital assets. Dobson v. Commissioner, 1944, 321 U. S. 231-232, 64 S. Ct. 495, 88 L. Ed. 691."

Another decision directly contrary to that of the Court below is *Clifton* v. *Allen*, 101 F. Supp. 997 (M. D. Ga., 1952), involved substantially identical facts. Counsel is informed that this decision is pending on appeal to the United States Court of Appeals for the Fifth Circuit.

The decision of the Court below is also contrary to a series of decisions of the United States Tax Court uniformly upholding the right to deduct ordinary losses in this situation:

Stanley Switlik, 13 T. C. 121, affd. 184 F. 2d 299 (C. A. 3d, 1950);
Frederick Bauer, 15 T. C. 876, reversed by the 2d Circuit Court of Appeals, 193 F. 2d 734 (1952). Petition for writ of certiorari to this Court granted June 9, 1952;
Frederick M. Paist, T. C. Memorandum Docket No. 23334 (Oct. 11, 1951);
Lamar D. Fain, T. C. Memorandum Docket No. 29674 (Jan. 10, 1952), appeal pending in C. A. 5th.

The decision of the Court of Appeals herein also reversed the decision of the United States Tax Court in this case, Seth M. Milliken, 15 T. C. 243.

This reversal of a long and uniform series of decisions by the United States Tax Court is an additional reason for granting review in this case. As this Court said in *Dobson* v. *Commissioner*, 320 U. S. 489 (1943), at page 499: "Consideration of uniform and expeditious tax administrations require that they (decisions of the Tax Court) be given all credit to which they are entitled under the law."

B. The decision below unjustifiably disregards the clear wording of the statute.

When the petitioner paid part of Ellingwood's tax deficiencies in 1942 he suffered a loss, as both the Tax Court and the Court of Appeals recognized herein. On its face, the Internal Revenue Code, Section 23 (e) (2) gives the petitioner the right to an ordinary deduction for this loss, and the Tax Court so held. However, the Court of

Appeals herein ruled that the loss was a long term capital loss governed by Internal Revenue Code, Section 117. But that section defines capital gains and losses as those resulting "from the sale or exchange of a capital asset", Section 117 (a) (2) (3) (4) and (5).

The 1942 loss did occur after the 1941 exchange and petitioner would not have suffered the loss had he not made the exchange. It does not follow that the loss resulted from the exchange so that Section 117 applies to make it a capital loss.

The Court below rested its decision on the theory that the 1942 payment by petitioner "operated to reduce the amounts received" in the 1941 exchange. But this in itself does not suffice to make it a loss from the prior exchange. Every time property is acquired by purchase or exchange a later loss arising from the ownership of the property may operate to reduce the value of the property. To relate all such losses to the prior capital transaction would emasculate the specific provisions of the Code permitting their deduction.

It is of no significance that petitioner received the property in exchange for stock in a corporate liquidation rather than in another type of exchange or by purchase, for the operation of the rule is not limited to transactions of the former type. The element which connects the later gain or loss with the earlier sale or exchange seems ordinarily to be that the receipt of future gain or the assumption of future loss was an element of bargain between the parties to the sale or exchange. A recent example is *Duveen Bros., Inc.* v. *Commissioner,* F. (2d) (C. A. 2, May 21, 1952) which the Circuit Court regarded as being governed by its decision in the present case. There the taxpayer incurred a loss by a payment in 1945 under an agreement made in connection with a sale of stock in an earlier

year, to guarantee the purchaser against loss. The liability under the guaranty was contingent and its amount therefore unknown to the taxpayer at the time of the sale but the risk was contemplated at the time and expressly assumed under the agreement of sale. Similarly, in *Holdcroft Transportation Company* v. *Commissioner*, 153 F. (2d) 323 (C. C. A. 8, 1946) where taxpayer acquired a business in a tax-free exchange pursuant to the terms of which taxpayer assumed the transferor's liabilities, it was held that payments by the taxpayer, in settlement of lawsuits pending against its transferor and known to the taxpayer at the time of the transfer, were capital expenditures and not ordinary losses; and the fact that the liabilities were contingent at the time of assumption by the taxpayer was regarded as immaterial. A contrary result is found in *Mitchell* v. *Commissioner*, 99 F. (2d) 778 (C. C. A. 2, 1938) where a liability relative to money received existing unsuspected by the taxpayer at the time of the original capital transaction, was asserted against him years later.

Another example of the distinction above illustrated is the treatment of losses from voluntary demolition of buildings. Where demolition is contemplated by the purchaser at the time of purchase, the value of the building at the time of demolition becomes part of the purchaser's capital investment in the remainder of the property. *Providence Journal Co.* v. *Broderick*, 104 F. (2d) 614 (C. C. A. 1, 1939). On the other hand, where use or alteration of the building is contemplated at the time of purchase and the purchaser later finds that a latent defect, unknown to him but existing at the time of purchase, precludes the contemplated use, the loss resulting from demolition is deductible under Section 23 (e). *Union Bed & Spring Co.* v. *Commissioner*, 39 F. (2d) 383 (C. C. A. 7, 1930).

The decision in each of these cases seems to depend upon when the original capital transaction is regarded as

closed. Clearly such a transaction is not closed as long as all the benefits and detriments contemplated by the parties in the transaction have not been realized. This appears to be the rationale of such cases as *Burnet* v. *Logan*, 283 U. S. 404 (1931) and *Commissioner* v. *Smith*, 324 U. S. 177 (1945). The Court below, while recognizing the rationale, first denies its application to the present case and then points out that in any event the transferee of the dissolved corporation must "contemplate the possibility of post-liquidation liability". The possibility of post-liquidation liability was no more remote in *Mitchell* v. *Commissioner* (*supra*) cited but not distinguished by the Court below, in which the opposite result was reached.

Mere possibilities of future loss or future recovery evidently do not prevent the closing of a transaction for tax purposes. But the precise circumstances which bring about the closing of a transaction have been inadequately defined. Compare *United States* v. *S. S. White Dental Manufacturing Company*, 274 U. S. 398 (1927).

The apparent conflict between the decision of the Court below in this case and earlier decisions of the same and other courts in regard to the questions above presented, as well as the inconsistency in principle between the decision of the Court below on this question and its decision on the second question referred to in the foregoing petition, creates confusion in the interpretation of the Code which should be clarified by this Court.

C. The pending case of *Arrowsmith and Bauer* v. *Commissioner* is not decisive of this case.

On June 9, 1952 this Court granted a writ of certiorari to review the decision of the Court of Appeals for the Second Circuit in *Arrowsmith and Bauer* v. *Commissioner*. That case is numbered 51 on the docket of this Court for the October 1952 Term and has been assigned to the sum-

mary docket. Counsel are informed and believe that that case will be argued during the week of October 20, 1952. Although the decision of the Court of Appeals in the *Bauer* case was substantially in conflict with the Third Circuit's decision in *Switlik* v. *Commissioner, supra,* the facts therein are somewhat different. There, at the time of the corporation's liquidation, a suit was pending against the corporation and the subsequent result of that litigation was a judgment against the corporation, resulting in liability to the shareholder-transferee. Although the exact extent of the liability had not been ascertained at the time of the dissolution, its general nature was then known. However, in both the *Switlik* case and in the instant case, the transferee liability was not asserted until after the corporation's dissolution. The dissolution herein is, therefore, a closed transaction and the decision below constituted an unwarranted extension of the Court's decision in *Bauer* v. *Commissioner.*

POINT II

This Court should review the erroneous decision below concerning petitioner's receipts from his Cotwool Manufacturing Corporation stock.

A. The decision below involves the same basic problem as does petitioner's payment of Ellingwood's tax liability (Point I hereof).

Petitioner suffered a loss stemming from an exchange which occurred in a prior tax year. The Court below decided (with respect to the Ellingwood tax liability discussed in Point I) that taxation of this loss is not governed by the specific statutory provision covering it, but that it is regarded as part of the original capital transaction, and therefore a capital loss.

Petitioner realized a gain stemming from an exchange which occurred in a prior tax year. On this point (with

respect to the Cotwool gains) the Court below held that the tax should not be governed by the nature of the earlier exchange.

These are aspects of the same fundamental problem of tax law, which demand clarification by this Court. The inconsistency inherent in the decision below is not merely unjust but inevitably tends to inject confusion into the tax law.

B. The decision below conflicts in principle with decisions of this Court.

When petitioner sold his Cotwool stock on June 28, 1940 he received, as consideration for it, in addition to cash and notes, the right to buy certain corporate stocks of various southern mills, as mentioned above. At that time none of these rights or options had any ascertainable market value. Internal Revenue Code, Section 111 (b) provides:

> "(b) Amount realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

The tax on gain or loss thus depends in part upon the "fair market value of the property" received, here, the rights to buy the various mill stocks. The statute does not say how or when the taxable gain is computed if the fair market value is not immediately ascertainable. However, this Court has held that in such a case the gain is taxed when the value becomes fixed by some subsequent event, *Burnet* v. *Logan,* 283 U. S. 404 (1931). There the taxpayer in 1916 sold capital stock of an iron mine company and received cash, plus a royalty on all iron ore subsequently taken from the mine. During the years 1917 to 1920 the purchaser paid these royalties to the taxpayer

and the Commissioner claimed that they constituted taxable income to her. The Court held, however, that the payments were not taxable as royalties since the 1916 transaction was not a closed one. It held that the payments constituted a return of capital because they were all part of the sales price under the 1916 transaction. The Court stated in part:

> "The 1916 transaction was a sale of stock—not an exchange of property. We are not dealing with royalties * * * The consideration for the sale was $2,200,000 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one" (283 U. S. 404 at pp. 412-3).

Subsequent cases make it clear that the same principle applies to receipts in excess of the basis and that these are taxed as capital gain.

> *Commissioner* v. *Carter*, 170 F. 2d 911 (C. A. 2, 1948), and
> *Westover* v. *Smith*, 173 F. 2d 90 (C. A. 9, 1949).

This general principle has been applied to stock options, *Commissioner* v. *Smith*, 324 U. S. 177 (1945). There an employee received an option to buy stock at a price equal to its then market value. In a later year he exercised the option when the value of the stock greatly exceeded the option price. The Court held that the option was given for the purpose of providing compensation, and it therefore stated:

> ". . . And as the option was not found to have any market value when given, it could not itself operate to compensate respondent . . . Hence the compensation for respondent's services, which the

parties contemplated, plainly was not confined to the mere delivery to respondent of an option of no present value, but included the compensation obtainable by the exercise of the option given for that purpose . . ." (324 U. S. 177, at pp. 181-2).

When in 1942 the petitioner learned that certain of the option stocks had substantially increased in value over the option price, he elected to take advantage thereof for the very purpose contemplated by the parties in the 1940 contract of sale. In accomplishing that purpose the amount of additional payment for his sale of Cotwool was thereby fixed and ascertained (*Commissioner* v. *Smith, supra*), and the 1940 transaction was closed *pro tanto* (*Burnet* v. *Logan, supra*).

C. The Court below erroneously applied I. R. C. Section 117 (g) (2) contrary to its plain meaning, and contrary to accepted principles of tax law and common law.

The Courts below escaped the application of the principles illustrated by the *Logan* and *Smith* cases by noting that petitioner did not in fact purchase certain of the stocks covered by the option, and by assuming that his receipt of $27,848.24 was, therefore, a gain attributable to the "failure to exercise" the option within the meaning of I. R. C., Section 117 (g) (2). What petitioner actually did was to convert the option (by notifying the optionor of his decision to exercise it) into a fully matured right upon which he could have brought suit. That he subsequently received cash in a negotiated settlement equivalent to the amount of damages he would have recovered in an action at law, instead of enforcing the right and receiving the stocks themselves, does not affect the nature of the transaction and its tax consequences. *Lyeth* v. *Hoey*, 305 U. S. 188 (1938); *Margery K. Megargel*, 3 T. C. 238 (1944). His receipts whether cash or stock stemmed from and were attributable to the 1940 agreement and his affirmative ac-

tions thereunder. The mere fact that litigation was not resorted to in producing the settlement is immaterial.

In any event, in applying Section 117 (g) (2), the Courts below completely overlooked the basic distinction between "failure to exercise options" to which the statute refers and failure to purchase the property subject to the option, which is *not* covered by the statute.

The exercise of an option is simply an offeree's acceptance of an offer. 1 *Williston on Contracts*, Sec. 25. An option is an agreement by the offeror not to revoke his offer for a specified period of time, 1 *Williston*, Sec. 61; *Shubert Theatrical Co.* v. *Rath*, 271 F. 827 at 833 (C. C. A. 2d, 1921). When the offeree or optionee appropriately signifies his assent to the offer, the offer is accepted, the option is exercised, and a new contract is made. See *Heller* v. *Pope*, 250 N. Y. 132 (1928). At that point the option no longer exists and in its place is an actionable right to buy, and obligation to sell, the property with respect to which the option or offer had been given.

The common law precedents have construed the phrase "exercise of an option" to signify the election to assert and take advantage of the option or privilege possessed, and taking action with respect thereto, notwithstanding that due to some intervening factor the right into which the option by its exercise, ripened, was not enforced according to its terms. *Drake* v. *Gaffney*, 183 App. Div. 577, aff'd 228 N. Y. 596 (1920); *Snead* v. *Wood*, 24 Ga. App. 210. Accordingly, the Tax Court's finding of fact herein that "the petitioner indicated in the early part of 1942 that he intended to exercise his option . . . to buy certain specified securities" was in effect a finding that there was no "failure to exercise" the option. The decision of the Court below in regard to the application of Section 117 (g) (2) was in error in two respects: first, in holding that within

the meaning of that section there was a failure by petitioner to exercise a privilege or option to buy or sell property; second, in holding that the express provisions of that section override the rule of *Burnet* v. *Logan* (*supra*) and *Commissioner* v. *Carter* (*supra*).

Even assuming that Section 117 (g) (2) would properly apply to such a transaction if it were isolated from its 1940 origin, that section is made irrelevant by the rule of the *Logan, Carter* and *Smith* cases. For example, the decision of the *Logan* case overrules the specific reference in Internal Revenue Code, Section 23 (a) (1) to royalties as ordinary income; instead it taxed the subsequent receipts from the sale as return of capital. In its very same decision herein the Court below, referring to the Ellingwood transferee liability payment, disregarded the express provisions of Internal Revenue Code, Section 23 (e), relating to losses, because, it said, nothing should "be permitted to obscure the fact that it was related to, and therefore *viewed practically* was a reduction of, a previous capital gain or an increase of a previous capital loss." (Emphasis supplied.)

Thus the decision below creates confusion in the tax law by disregarding the plain wording of the statute, I. R. C., Sections 23 (e) and 117 (a) (on the "Ellingwood point"), so that the matter can be "viewed practically". Then, it adopts the directly opposite approach on the "Cotwool point", and disregards the practicalities because, it said, "When we are given a statutory guide in a difficult field, we see no basis for making confusing exceptions to its general terms." Moreover, the decision of the Court below was wrong on both points. It treated the 1940 sale of Cotwool stock as a closed transaction, whereas it was not closed because the stock options had no ascertainable fair market value at the time they were created by the 1940 agreement. On the other hand it treated the 1941

corporate liquidation of Ellingwood as an open transaction whereas it was closed because the tax liabilities later asserted were not known or contemplated at the time of the exchange.

CONCLUSION

It is respectfully submitted for the foregoing reasons that the petition should be granted and that a writ of certiorari should issue to the United States Court of Appeals for the Second Circuit for a review of its decision and judgment herein by this Court.

Respectfully submitted,

JOHN W. BURKE, JR.,
Attorney for Petitioner.

APPENDIX A

Provisions of the United States Internal Revenue Code

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions: • • •

(e) Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise— • • •

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business;

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(b) Amount realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Sec. 117. Capital Gains and Losses.

(a) Definitions.—As used in this chapter—

(1) Capital assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) • • •

(3) Short-term capital loss.—The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such loss is taken into account in computing net income; • • •

(4) Long-term capital gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;

(b) Deduction From Gross Income.—In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 per centum of the amount of such excess shall be a deduction from gross income.

(g) Gains and Losses from Short Sales, Etc.—For the purpose of this chapter— • • •

(2) gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short-term capital gains or losses; • • •

In the Supreme Court of the United States

OCTOBER TERM, 1952

No. 185

SETH M. MILLIKEN, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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MEMORANDUM FOR THE RESPONDENT

This case presents three separate issues. The Tax Court's determination of one of the issues was reversed by the court below on the Commissioner's appeal, and its determination of the other two was affirmed on the taxpayer's appeal. The only issue which gives rise to a conflict of decisions is the one with respect to which the court below reversed the Tax Court, and the Commissioner does not oppose the granting of a writ of certiorari limited to that issue. The affirmance by the court below of the

Tax Court's decision of the other issues presents no conflict and no occasion for further review.

1. The issue on which the court below reversed the Tax Court (the first question presented by the petition for certiorari (Pet. 2)) is whether a stockholder who realizes a capital gain or loss on the liquidation of a corporation, and in a subsequent year pays a debt of the corporation in satisfaction of his liability as transferee of the corporate assets, may deduct the payment as an ordinary loss under Section 23(e)(2) of the Internal Revenue Code or is required to treat it as a capital loss deductible only to the extent provided in Sections 23(g) and 117. The Tax Court held (R. 11a), that the payment was deductible as an ordinary loss, upon the authority of its decision in *Switlik* v. *Commissioner,* 13 T. C. 121, affirmed by the Court of Appeals for the Third Circuit, 184 F. 2d 299. The court below followed (R. 26-27) its own contrary decision in *Commissioner* v. *Arrowsmith* (*Bauer*), 193 F. 2d 734, and held it to be deductible as a capital loss. A petition for a writ of certiorari has been granted in the *Arrowsmith* case No. 51, this Term, certiorari granted, 343 U. S. 976, and the question will be resolved by the Court's decision in that case. The Commissioner does not oppose the granting of the writ, limited to that question, in order that this case may be decided in conformity with the Court's decision in *Arrowsmith*. Alternatively, the Court

may wish to postpone action on the present petition until *Arrowsmith* has been decided.[1]

2. As for the other two issues, on which the court below affirmed the Tax Court, no ground exists for granting the writ.

The first of these issues is whether taxpayer realized a long-term or short-term capital gain by reason of his non-exercise of an option. Taxpayer acquired an option to buy securities at a specified price, and in consideration of a payment to him by the optioner he agreed to and did refrain from exercising the option. (R. 7a-8a.) The Tax Court held (R. 10a-11a), and the court below agreed (R. 21-22), that the gain thus realized constituted a short-term capital gain by virtue of the express provision of Section 117(g)(2) of the Internal Revenue Code that "gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short-term capital gains or losses." Taxpayer's contention (Br. 19-22) that the gain was not "attributable to the 'failure to exercise'" the option within the meaning of that section, because it was received as consideration for his agreement not to exercise it, is patently untenable and was properly rejected by

[1] We are informed that the *Arrowsmith* case has been set for argument in this Court during the week of October 20, 1952. A petition for certiorari has also been filed in *Duveen Brothers, Inc.* v. *Commissioner*, No. 210, presenting the same question, which was decided by the Court below on the authority of its decisions in *Arrowsmith* and this case.

both courts below (R. 9a-11a, 21-22). As the Court of Appeals stated (R. 22), taxpayer "admittedly did not invoke his option to secure the securities to which it entitled him, and the money he received therefor is directly 'attributable' to his non-exercise of his right and thus is within the categories of the statute." Taxpayer asserts (Pet. 5-6, Br. 17-19) that the decision below is "probably in conflict" with *Burnet* v. *Logan,* 283 U. S. 404, and *Commissioner* v. *Smith,* 324 U. S. 177, rehearing denied, 324 U. S. 695. But neither of those cases involved the application of Section 117(g)(2), as does the instant case; indeed, they presented questions far removed from the question of whether a gain attributable to the non-exercise of an option represents long-term or short-term capital gain.[2]

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[2] In the *Logan* case a vendor received the vendee's promise of uncertain future payments as part of the purchase price, and it was held that the future payments represented a return of capital applicable against the basis of the property sold, rather than ordinary income. In the *Smith* case an employee received and exercised an option to purchase some of his employer's property, and it was held that the employee realized additional "compensation" (ordinary income) upon the exercise of the option under Section 22(a) and the Treasury Regulations addressed to that section. Taxpayer's reliance (Br. 18) upon *Commissioner* v. *Carter,* 170 F. 2d 911 (C.A. 2), and *Westover* v. *Smith,* 173 F. 2d 90 (C.A. 9), is equally misplaced since neither of those cases involved an option, much less a failure to exercise one. There stockholders of a corporation in liquidation received an assignment of the corporation's contract claims against a third party, the value of which was unascertainable, and it was held that the

The other issue on which the court below sustained the Tax Court is whether taxpayer realized a long-term or short-term capital gain upon the retirement of a corporate note acquired through the exercise of an option. In June, 1940 taxpayer acquired an option to purchase the note at a fraction of its face amount, in November, 1941 he exercised the option, and within six months thereafter he collected the face amount of the note. (R. 7a.) Whether the gain realized upon retirement of the note constituted a short-term or long-term capital gain depends on whether the period for which the note was held is to be measured from the date taxpayer acquired the option to purchase it, or from the date he acquired ownership of the note by exercising the option. Section 117(a)(2) and (4), and (f) of the Internal Revenue Code.[3] The Tax Court held (R. 11a-12a) that "the period during

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amounts realized by the stockholders represented capital gain from the exchange of their stock for the corporate assets, rather than ordinary income. Significantly, the *Carter* case was decided by the court below, which considered it inapposite here. (R. 21-22, 24-25.)

[3] Section 117(a)(2) defines "short-term capital gain" as "gain from the sale or exchange of a capital asset held for not more than 6 months," while Section 117(a)(4) defines "long-term capital gain" as "gain from the sale or exchange of a capital asset held for more than 6 months." Section 117(f) provides that "amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation * * * shall be considered as amounts received in exchange therefor."

which the petitioner owned the indebtedness was less than 6 months," and accordingly held that the gain was short-term capital gain—as the taxpayer had reported it in his return.[4] The court below concurred (R. 24-25), and its decision is in accord with *Helvering* v. *San Joaquin Co.*, 297 U. S. 496. See also *McFeely* v. *Commissioner*, 296 U. S. 102; *Mack* v. *Commissioner*, 148 F. 2d 62 (C.A. 3), certiorari denied, 326 U. S. 719; *Kinkel* v. *McGowan*, 188 F. 2d 734 (C.A. 2). Taxpayer claims (Pet. 5-6, Br. 17-18) conflict with the same cases upon which he relies in connection with the issue relating to his non-exercise of an option. Those cases are clearly inapplicable, for they in no way turned upon the holding period of a capital asset acquired by the exercise of an option. See fn. 2, *supra*. As the court below observed (R. 24-25), they "have no application to the period of holding. Contrary to taxpayer's contention, they can neither push the acquisition date back nor advance the time of a sale or exchange for purposes of the long term-short term dichotomy."

We respectfully submit that if the writ is granted it should be confined to the first question

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[4] Although the Tax Court held that taxpayer had properly reported the gain as short-term capital gain, taxpayer contended in the Court of Appeals (R. 22-25), as he does here (Pet. 2-3), that he should have reported it as long-term capital gain.

presented by the petition. The decision below on the other issues is correct, and presents no conflict or occasion for further review.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

AUGUST, 1952.

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IN THE

Supreme Court of the United States

October Term—1952

No. 185

SETH M. MILLIKEN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MOTION FOR LEAVE TO FILE AND PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

JOHN W. BURKE, JR.,
Counsel for Petitioner.

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MOTION FOR LEAVE TO FILE PETITION FOR REHEARING

Seth M. Milliken, the petitioner, respectfully moves for leave to file the annexed petition for rehearing of the order of this Court entered November 17, 1952, denying the petition for writ of certiorari in this case. Rehearing is now sought because, as pointed out more fully in the annexed petition, the decision of this Court in *Arrowsmith et al.* v. *Commissioner of Internal Revenue,* —— U. S. ——, November 10, 1952, is in conflict with the decision of the Court of Appeals for the Second Circuit in this case on one of the questions presented, and on the other question presented the decision of the Court of Appeals herein raises problems of the scope and extent of the rule just set forth in the *Arrowsmith* case, *supra.*

JOHN W. BURKE, JR.,
Counsel for Petitioner.

Petition for Rehearing on Petition for Writ of Certiorari

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Your petitioner, Seth M. Milliken, hereby respectfully petitions this Honorable Court for a rehearing of his petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit to review the decision and judgment of that court herein, which petition for certiorari was denied by this Court on November 18, 1952.

Statement Under Rule 33

The basis for jurisdiction, questions presented, statutes involved, statement of facts and reasons for granting the writ are set forth in the original petition for writ of certiorari herein.

Pursuant to Rule 33, this petition for rehearing is respectfully submitted on the ground that the decision of this Court in *Arrowsmith et al.* v. *Commissioner of Internal Revenue,* —— U. S. —— (November 12, 1952, Docket No. 51), constitutes an intervening occurrence of controlling effect on the second question presented herein. That question is, as set forth in the original petition herein:

> Was it not error for the Court of Appeals to hold petitioner should be taxed as short term, not long term, capital gain the $58,372.44 he received in 1942 (in three payments) for certain rights and assets he had previously obtained in exchange for corporate stock of Cotwool Manufacturing Corporation which he had owned for many years?

The decision of this Court in *Arrowsmith et al.* v. *Commissioner of Internal Revenue, supra,* is also of substan-

tial effect on the other question presented in the original petition herein, and for the purpose of clarifying an important and basic question in the administration of Federal income tax law, this Court should consider and determine the scope of the rule of the *Arrowsmith* case as applied to this question:

> Was it not error for the Court of Appeals to hold that petitioner could only deduct as a capital loss, not an ordinary loss or expense, $33,411.29 he paid in 1942 in settlement of transferee liability asserted against him because in 1941 he had received assets of the dissolved Ellingwood Corporation in exchange for its corporate stock?

Reasons for Granting the Writ

1. In 1942 petitioner realized gains by using the rights he had obtained in an exchange which had occurred in a prior tax year. At the time of the prior exchange these rights had no ascertainable fair market value. At the time of the earlier exchange the petitioner had held the assets which he then exchanged, for many years, so that his gain was a long term capital gain. The question presented is whether the petitioner's additional receipts in 1942 are to be characterized, taxwise, as part of the exchange which had been previously only partly consummated. The United States Court of Appeals held herein that these gains were not to be so characterized. The petitioner contended below, and herein, that they should be so characterized. The decision of this Court in *Arrowsmith et al.* v. *Commissioner of Internal Revenue, supra,* holds that when a loss results from an exchange* which occurred in a prior year, the de-

* In that case, the exchange was a shareholder's exchange of his stock in a corporation for a pro rata share of the corporate assets.

ductibility of the loss must, for tax purposes, be characterized by the nature of the earlier exchange. The opinion of the Court in the *Arrowsmith* case is in all respects just as applicable to subsequent gains as it is to subsequent losses.

Since this Court has just held that subsequent losses are to be taxed as capital losses in these circumstances, so it should now hold that these gains should be taxed as long term capital gains.

The decision of the United States Court of Appeals herein refusing to characterize petitioner's gains in the light of the prior exchange can only be upheld if this Court wishes to limit the apparent scope of its reasoning in the *Arrowsmith* case. Although we know of no reason for such a limitation on the rule just announced by this Court, if there is to be any such limitation it should be announced by this Court to avoid utter confusion in the administration of the Federal income tax law.

2. If the rule of the *Arrowsmith* case requires any delimitation and clarification, this Court should provide the clarification. The other issue presented in this case provides an ideal opportunity for this type of clarification. In 1941 petitioner herein, as a shareholder of Ellingwood Corporation, received his pro rata share of its assets in the complete liquidation and dissolution of that corporation. Subsequently, in 1942 tax deficiencies were asserted against Ellingwood, which were not anticipated at the time of the liquidation, and which were compromised and settled by petitioner as transferee. The United States Court of Appeals below held, that even though the 1941 liquidation was apparently closed, assuming that the tax deficiencies were not then foreseeable, the petitioner's later payment of these taxes constituted a capital loss. In the *Arrowsmith* case,

in which this Court reached the same conclusion, the liability subsequently paid by Arrowsmith was one which the taxpayer knew about at the time the corporation was liquidated. This Court held that the fruition of that foreseeable liability should be taxed in the same way as the original loss on the liquidation, that is, as a capital loss. As indicated in the dissenting opinion in the *Arrowsmith* case, this raises some question as to the scope of this new rule which replaces the previously accepted rule of numerous Tax Court decisions.

It would seem that a transaction which is apparently closed to all effects and purposes (as in the present case) need not be reopened in a later year even though transactions, which are recognized as incomplete because of pending litigation (as in the *Arrowsmith* case) will be held open.

In any event, by now deciding this question on the merits, this Court can avoid the doubts and conflicts referred to in the dissenting opinion in the *Arrowsmith* case.

WHEREFORE your petitioner respectfully prays for a rehearing on the application for certiorari and that a writ of certiorari be issued directed to the United States Court of Appeals for the Second Circuit in respect of its decision and judgment, modifying the determination of the United States Tax Court, for a review thereof by this Court, and for such other relief as to this Court may seem proper.

Dated: New York, New York, November 28, 1952.

SETH M. MILLIKEN,
Petitioner,

By JOHN W. BURKE, JR.,
Attorney for Petitioner.

Certificate of Counsel

I hereby certify that I have examined the foregoing petition for a rehearing; it is presented in good faith and not for delay; in my opinion it is well founded, the cause is one in which the petition should be granted, and this petition is restricted to the grounds specified in Rule 33.

Dated: November 28, 1952.

JOHN W. BURKE, JR.,
Attorney for Petitioner.